DOW THEORY LETTERS INC.

RICHARD RUSSELL
P. O. BOX 15196
SAN DIEGO, CALIFORNIA 92115

Registered with the Securities Exchange Commission

40 Letters per Year — $50.00 Annually

THE MARKET: According to Dow's Theory, a bear signal is rendered as follows: (1) a full secondary reaction occurs; (2) in the recovery that inevitably follows, one or both Averages fail to establish new highs; (3) the two Averages then turn down and violate their preceding secondary lows. This definition, of course, implies that a full secondary reaction must first take place (and that a rally must follow) before an orthodox bear signal can be rendered.

Also, according to Dow's Theory when the two Averages rise to new highs, the significance of all preceding levels is erased. Referring to the current market, since new highs were registered by the two Averages in October, the preceding August lows "should be" meaningless.

But what happens if the two Averages rise to new highs, and then turn down and just keep going? At what point does one "throw in the sponge?" The great analyst, Robert Rhea, covered this point in his book The Dow Theory: "When declines in a primary bull market result in violating the lowest points encountered during the last major secondary reaction of that market, it may generally be assumed that the primary trend has changed from bullish to bearish."

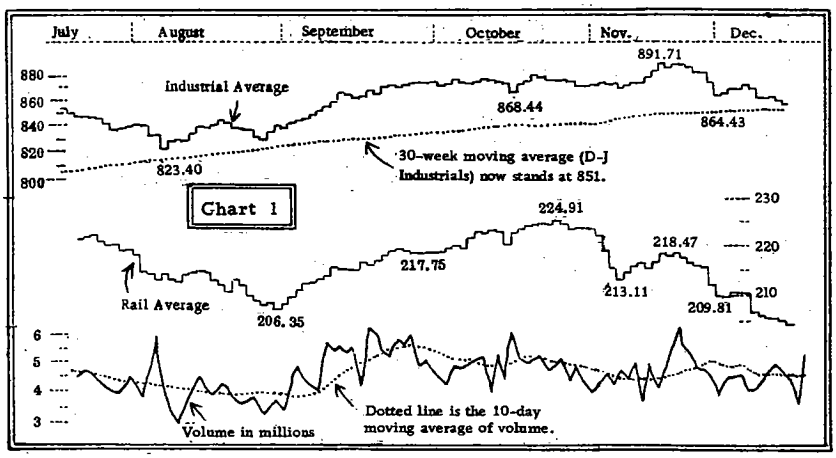
All of which brings up this critical question: "What would it mean if the Industrial Average continued straight down and violated its August (823.40) low? (Remember, the Rail Average has already broken below its August low). Here is my answer: although the August lows were not "full secondary lows" (the July-August Industrial decline was too shallow), it is nevertheless my opinion that a high volume penetration of 823.40 by Industrials should be taken as the signal for a reversal in the primary trend.

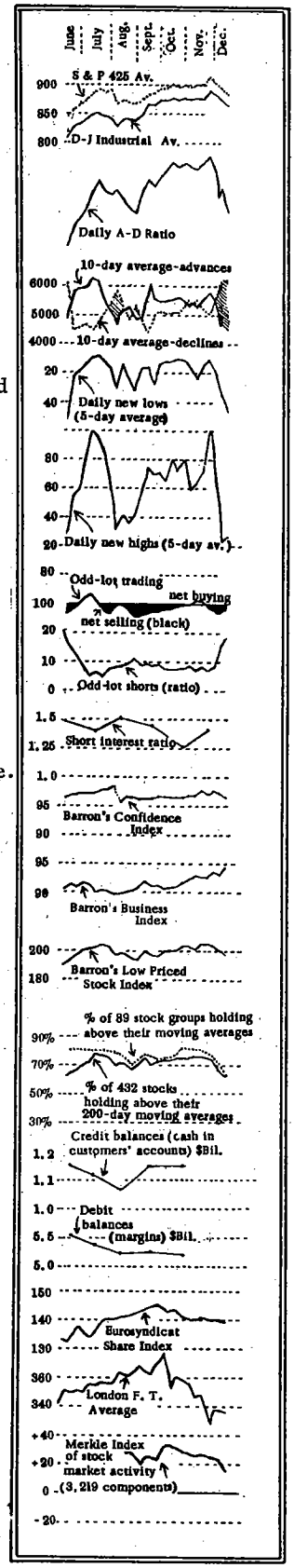
In the meantime, I believe that subscribers should (as we have most of the year) assume a sceptical but not yet completely bearish attitude toward the market. Sceptical in that they should be holding very few stocks with the exceptions of golds. Not yet bearish because Dow's Theory states that a trend is taken to remain in force until proved otherwise.

On December 15 the Industrial Average closed at 857.45, within 4 points of its 30-week moving average. This was followed by a dull rally on December 16. As far as I am concerned, there is nothing wrong with "watching the show from the sidelines," and in a market as treacherous and difficult as this one I have continually advocated such a policy. Furthermore, I believe (with the exception of gold buyers) that the "watchers" have probably done as well as the "investors" during 1964 to date.

The Composite Chart continues to reflect market deterioration. Note that the S & P 425 Industrial Average is now well below its July high (the July high for the DJI was 851.35). At the same time the A-D ratio has retreated to within a fraction of its August low (at which time the DJI was 823). (Also of interest is the fact that the widely-followed N. Y. Herald Tribune Average — not shown — has already broken its August low). Thus, the DJI continues to act better than most other indices and the blue-chip Dow stocks continue to outperform the great mass of N.Y.S.E. issues. This type of action in the past has not been a healthy one (nor has it usually been a profitable one).

Daily new highs (5 day av.) have dropped below 20 while daily new lows hold in the low 40's. Odd-lotters remain on the selling side of the market, but so far on the decline they have not increased selling. Thus I rate them as no more than neutral. Barron's Confidence Index has edged down to 96.7, and it is thus





holding within its range of the past 10 months. The same can be said of Barron's Low-Priced Stock Index which has held in a tight range for the past 9 months. The percentage of 89 stock groups holding above their moving averages has taken a sharp drop to 64% from a previous reading of 79%, while the percentage of 432 stocks holding above their moving averages has retreated to 63% (also a sharp dip). The 50% level, however, represents the critical point in both these studies. The peak in debit balances (margin accounts) occurred thirteen months ago in November, 1963. A declining trend in debits has (in the past) served to signal the end of many bull markets. The declining trend of debits since late '63 continues to be a long-term bearish consideration. The Merkle Index dropped sharply to 15 last week. As long as this Index holds in plus territory, however, it is saying that "all is not lost."

Conclusion: The indicators portray weakness, but like the Averages they have not yet reached the point of no return.

ADVANCE-DECLINE RATIO: The action of the A-D ratio has been one of the biggest puzzles of the entire 1962-64 rise. The ratio turned up in October, 1962 (following the 1962 collapse). After a seven-month climb (see Chart 3), the ratio struck a peak during the latter part of May, 1963. Following the May peak, the ratio displayed progressive weakness. After failing to record a new high in September (despite a series of all-time Industrial highs), the ratio turned down and broke its entire 1963 range (in November) on the shocking news of President Kennedy's assassination.

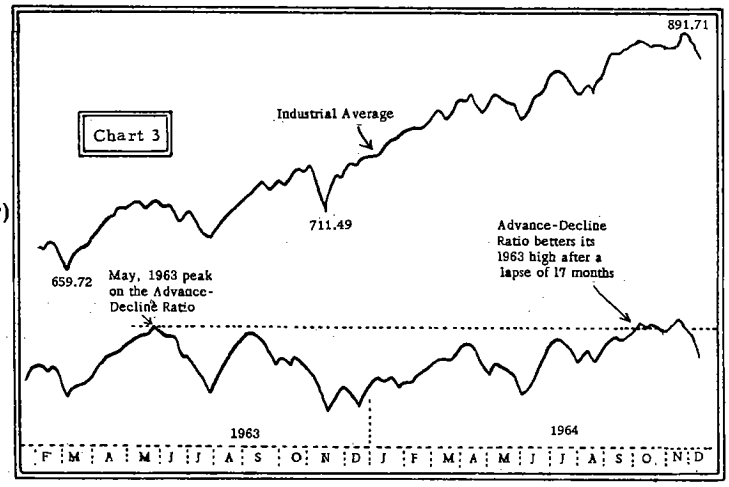


Chart 3
891.71
Industrial Average
711.49
659.72
May, 1963 peak on the Advance-Decline Ratio
Advance-Decline Ratio betters its 1963 high after a lapse of 17 months
1963
1964
F M A M J J A S O N D J F M A M J J A S O N D

To my knowledge, no bull market has ever survived such a poor performance on the part of the A-D ratio. As a matter of fact, in the past when the ratio has recorded a peak early in the year and has been unable to better that peak despite successive new highs in the Industrial Average, the result has always been a very bad time for the market during the following year. The recent history of such action is interesting:

1956-57: The A-D ratio established a peak in March, 1956, while Industrials recorded their peak in April of that year. A decline followed — then a rally into August, 1956. In August, Industrials rose to within a fraction of a point of the April peak, but the A-D ratio lagged badly. This process was repeated in April, 1957. In the July-October, 1957, period, trouble came. Industrials dropped 20% in a matter of three months.

1959-60: The A-D ratio recorded its high in the first half (March) of 1959, while Industrials rallied to new (unconfirmed) highs during the second half (August and again in December). The Industrial peak was struck on January 2, 1960, and from there a broad decline took the senior Average to an October, 1960, low of 566.05 (119 points below the January peak).

1961-62: The A-D ratio recorded its peak in the first half (May) of 1961, but Industrials extended their solo advance into the second half of the year, establishing new highs in August and again in December. What occurred the following year (i.e., in 1962) is too fresh in our minds to need repeating.

1964 provided market students with "something new." Instead of the trouble which normally might have been expected following the "topping out" of the A-D ratio in early 1963, the market gave forth with an extraordinary performance. The Industrial Average pushed steadily higher as seen on Chart 3. On October 9, the A-D ratio actually broke out of its trading range on the upside. Thus, instead of the mass of issues dragging the Industrial Average down, the Industrial Average literally pulled the majority of stocks above their 1963-64 trading range. This event was heralded with enthusiasm and amazement by technical students everywhere.

The improvement in market breadth was short-lived, however. The A-D ratio struck a high on November 18, 1964, then turned down with Industrials. Within a few days, the ratio fell back within its 1963-64 trading range again. As gauged by the A-D ratio (and probably by the bank accounts of most investors), the majority of stocks have shown little upside progress since May, 1963.

What can we expect next in the breadth-price drama? Is the trouble which "should have arrived in 1964" to be carried over into 1965? Was the fleeting new high in the A-D ratio a "technical trap", or do the mass of issues really want to go higher? This writer does not profess to know the answer, but as I study Chart 3, I am reasonably convinced of one thing: it is one devil of a trick making money in common stocks when the A-D ratio holds within a trading range (even though the Industrial Average rises to successive new highs). I doubt whether many amateurs or professionals would disagree with this observation.

LEADING ANALYSTS (Continued): Practical men with theoretical minds are hard to find. Mr. Hamilton Bolton of Canada (and Bermuda) is such a man. Bolton is editor of the famous Bank Credit Analyst, a monthly publication, which analyzes bank credit and other aspects of the market and the economy.

Bolton sees money as the "life-blood" of the economy. He believes that if one knows where money is going and what it is doing,

one can predict with a fair degree of accuracy what business and the market are going to do next. Bolton studies total money activities through such devices as bank debits, which represent all bank transactions; bank loans, money supply, etc. One of his most important indicators, in fact, is the debit-loan ratio. When this ratio rises, it shows that economic activity is increasing while loans are still conservative, a bullish situation. On the other hand, when banks are loaned up and activity drops off (declining debits), the situation becomes highly dangerous and under these conditions the debit-loan ratio declines. Movements of the debit-loan ratio historically precede major movements in the market, and this is just one of the devices which have helped to give Bolton such a superior forecasting record.

One of the interesting phenomena which Bolton is now directing attention to is the great velocity of demand deposits in New York. A marked acceleration of deposits in New York last occurred during the 1920's, and although we are not yet in the 1928-29 stage of deposit turnover, Bolton feels that this indicator is suggesting that we are now entering the same dangerous speculative environment which marked the latter stages of the boom of the '20's.

In the latest report Bolton warns readers not to dismiss comparisons of the present situation with those of the 1920's. He notes that the following similarities exist: (1) The sharp increase in velocity of demand deposits since 1960. (2) The large overall credit expansion (at an expanding rate) since 1960. (3) Increase in short-term interest rates. (4) Large shift from demand to time deposits. Finally, he notes that whereas the 1920's showed a big increase in stock market credit, we have an equally dangerous situation in the current huge expansion of non-bank credit (manufacturers and trade credit in the form of accounts receivable — in other words, "on the cuff" buying).

What does Bolton think now? Bolton's latest report states that none of his banking indicators "has yet reached critical stages." Bolton feels that because of the developing international monetary situation, the next bear market could be severe. However, for the present he sees no strong monetary or technical considerations which suggest that the bull market is in immediate danger of topping out. I might add that Bolton also uses a number of technical market tools such as a weekly advance-decline ratio, a group momentum index and the short interest ratio. These too, he rates as still on the plus side.

FRANCE: In all the reams of analyses and discussions which have appeared in the newspapers and magazines regarding monetary troubles, almost no one dares to mention the overriding critical factor of DeGaulle. But make no mistake about it, DeGaulle either foresees or desires (probably both) world deflation. He and his advisors have been clamping down on the French economy; they want France "near the ground" when deflation comes. Furthermore, DeGaulle sees France benefiting from deflation and even emerging as the leading power of the Free World in the event of deflation. In my opinion, DeGaulle believes that the U. S. and Britain (the inflationists) are heading for a dreadful fall, and that France with its heavy gold reserves will then rise in the mantle of the France of old — the Glorious Republic, leader of the West.

Listen to this recent quote from Mr. Giscard D'Estaing, Governor of the Bank of France (delivered before the I. M. F.): "The world monetary system must be set in concentric circles, the first one being gold ..... Experience in recent years has shown us that, aside from any theoretical preference, gold remains the essential basis of the world payment system."

This thinking is in direct conflict with the U. S.-Britain predilection for printing paper money. DeGaulle also knows that if Britain is forced to devalue, pressure will immediately switch to the dollar (which is the other reserve currency and is tightly bound to the pound). Is it any wonder that our journalists do not tell the real story of the U. S.-British predicament? Finally, DeGaulle with his large stockpile of dollars possesses the power to force a mammoth gold withdrawal here — simply by demanding gold for his 1.5 billion dollar holdings.

DeGaulle believes that from here on, history is on his side. He believes that the tide of U. S.-British inflationary politics is playing directly into France's hands. Only a very few people are aware of the scope of DeGaulle's ambitions and visions, but to be ignorant of them is to be oblivious of the greatest power struggle in the Free World today.

One of my cohorts who is well aware of this situation is Eliot Janeway, former business editor of Time Magazine. Janeway is a bit more optimistic about the whole picture than I am, and I include this paragraph from a personal letter which he sent me last week: "As to gold, it is DeGaulle's trump card — that is, if he ever gets a chance to play it. His best chance would be British devaluation. I'm inclined to think it's his only chance. Yes — there is a chance of British devaluation. After Wilson's performance in moving unilaterally to 7% bank rate, I can't say that the fact of his agreement with us to avoid devaluation will stop him from devaluing. But I'd be surprised if he did. And it is easier, it's more plausible politically and it's less costly economically for him to continue taking and paying out the reserves we cause to be advanced to him than to devalue."

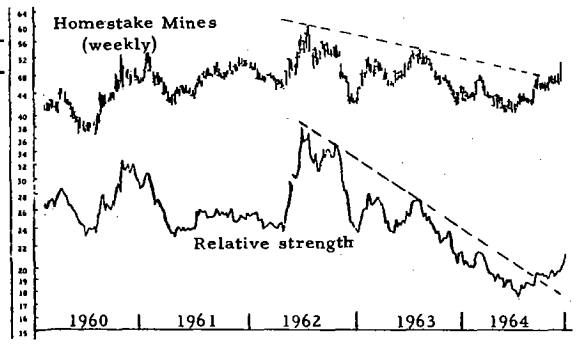
BUYING BILLS: A number of subscribers have written asking: "How do I buy 91-day Treasury bills?" These bills may be purchased (preferably in lots of $5000) from your bank or broker (commissions are negligible). The bills are purchased on a "discounted basis" which means that the interest is immediately subtracted from the purchase price and the full face value is returned in 91 days. Thus if someone had purchased $15 thousand of bills two weeks ago he would have paid approximately $14,850 and at the end of 91 days he would have received $15,000.

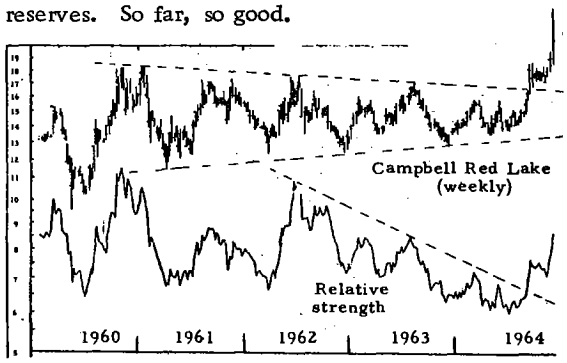
Orders may be given to "roll over" these bills, which means that a new batch of bills is automatically purchased every 91 days, and the interest is immediately credited to the customer's account. Obviously, bills may be sold at any time, and they are therefore considered to be almost the same as cash.

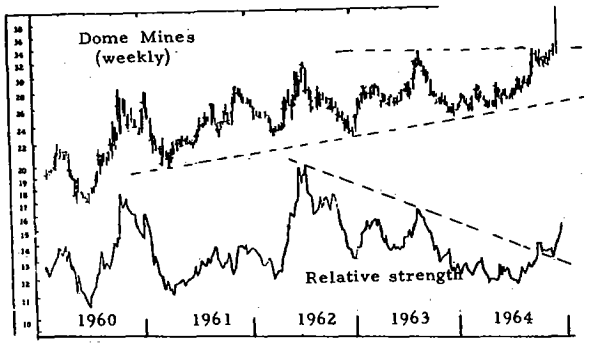
For those who want to be ultra-safe, a special trust may be opened at your bank. It should be specified that the trust will hold your Treasury bills, and that the trust is to be completely independent of the bank. Thus, if the bank runs into trouble, the assets of the trust will be absolutely separate from the bank's assets. Most people are unaware of it, but when you deposit money in a bank that money becomes part of the bank's assets until it is withdrawn (the same, of course, pertains to money left in brokerage houses).

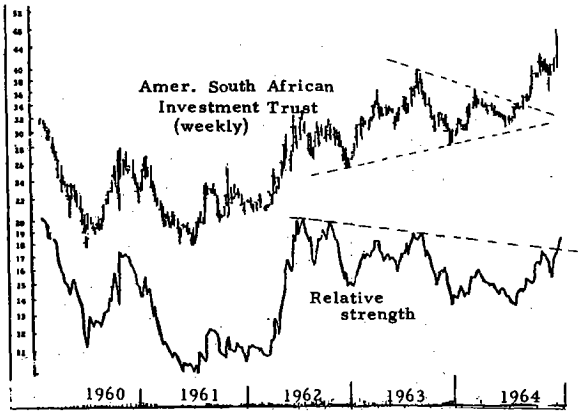
While I am at it, I might as well go the whole scary hog. A large percentage of bank deposits are insured by the Federal Deposit Insurance Corp., an agency set up by (although it is not a part of) the U. S. Government. Against $192 billions in insured bank deposits, the F. D. I. C. has $2.8 billions in reserves. These reserves are almost all in U. S. Treasury bonds. If any large part of these had to be sold, they could "break" the bond market. Furthermore, the savings and loans have $88 billions of insured accounts — all insured by a total of $1.2 billion in the Federal Savings & Loan Insurance Corp., (another Government agency). Finally, the Federal Housing Administration insures $43 billions of mortgages with $1.1 billion of reserves. Thus a total of $328 billions in assets is insured with $5.1 billions in reserves. So far, so good.

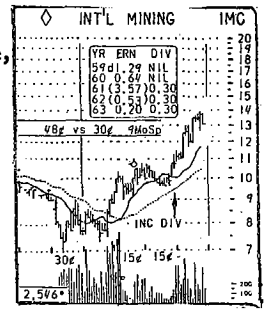
STOCKS: Most of my recent stock recommendations (Mohasco, Foremost, Grant, Schenley, Vendo) held relatively well during the recent onslought. But obviously, the money has been made in golds. International Mining, Dome, Campbell Red Lake, Amer.-South African have rocketed out of powerful base formations, and the charts speak for themselves. Homestake, the American gold mining and uranium producer, has just joined the group, and we note that HM's relative strength line has now reversed a two-year declining trend (I see nothing wrong with purchases of HM here). Meanwhile, Free State Geduld recommended at 17 in Letter 270 climbed to 19½, and President Brand recommended at 9¼ in Letter 269 has risen to 10½ (both of these are S. African stocks). President Steyn recommended in Letter 273 at 3 is now selling at 3 3/4, and I continue to recommend all three of these stocks. Mr. Ray of Ray * Signals (141 B'way, N.Y.C. 6) has been kind enough to furnish me with a rare chart of F.S. Geduld, and I doubt whether more than a handful of technicians in the country have seen this remarkable picture. Here we see F.S. Geduld rising out of what appears to be a four-year ascending triangle. At the same time its relative strength line has pushed out of a two-year downtrend. Technically, the stock appears ready to move to the middle 20's. (I bought it for a few accounts at 17½ and believe it is a good purchase at 20 or under).

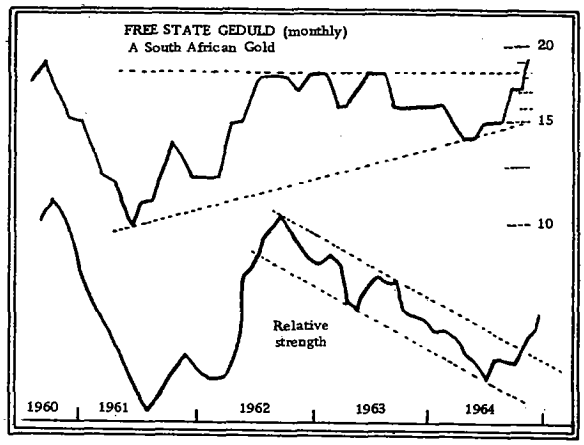












NOTE: Britain has just announced that November has produced an adverse balance-of-payments of $288 million against an adverse October B.O.P. of $257 million. This means that with the new 15% surcharge on British imports and the rebate on exports, the figures have worsened instead of bettered!

Large charts courtesy of Traders Research, 1431 Pearl Ave., Alton, Illinois 62003.
Chart of IMC courtesy of Quote Digest, 110 N. Lorraine, Wichita, Kansas.